VT Tyndall Global Select Fund Commentary

August 2019

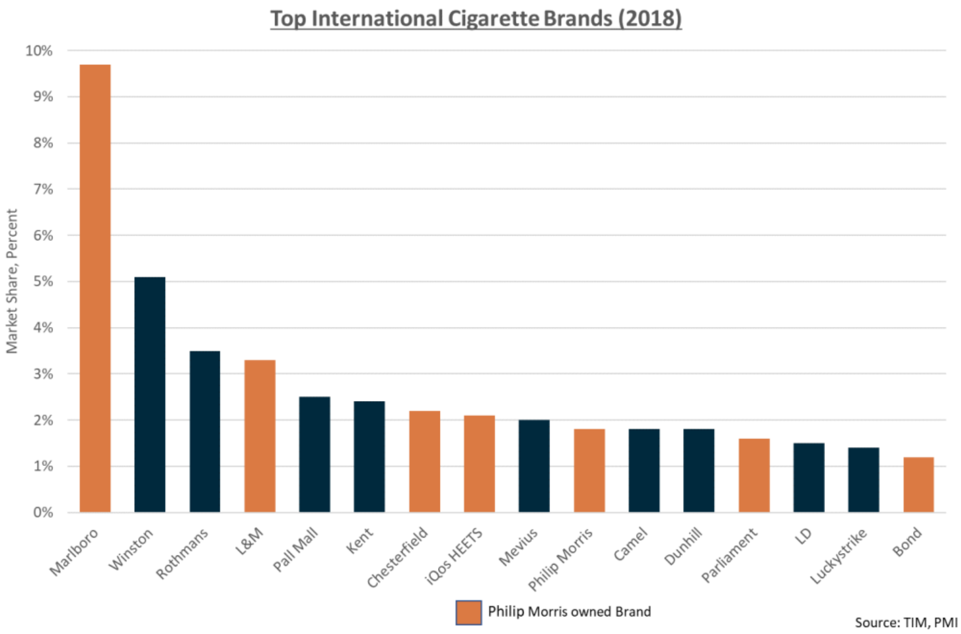
"Having heard all of this you may choose to look the other way, but you can never again say that you did not know."- William Wilberforce

August proved to be a volatile month as geo-politics played havoc with investor sentiment. Donald Trump's tweets on China swung regularly from President Xi being an 'enemy' to 'friend' and back again, Italy narrowly avoided a general election as Matteo Salvini withdrew his support from his coalition partner and in the UK Boris Johnson moved to prorogue parliament as he tries to exit the EU at the end of the October. All the above led to multiple large intraday swings in both stock market levels and currency exchange rates as market participants evaluated the knock-on effects on the global economy.

The VT Tyndall Select Fund B Inc was not totally immune to the market turbulence, falling by 0.85% bringing the year-to-date returns to 25.16%

During the month there were no outright sales or purchases of positions, however we took advantage of the market volatility seen in August to add to our holdings in Kao, Rational, Thermo Fisher Scientific, Nike and Visa, all of which had experienced corrections despite their underlying businesses remaining strong. We reduced the size of our position in Microsoft; however, it remains to be one of the top 10 holdings within the fund. Although Microsoft has returned over 680% since our initial investment, we believe that under Satya Nadella the company can continue to outperform the market, however, in line with our ongoing risk management, we reduced the position from 5% of the Fund.

Our holding in Philip Morris International (PMI) underperformed over the month after announcing that it was in talks to re-merge with Altria 11 years after Philip Morris split into separate entities. The split left Altria controlling the Philip Morris tobacco products within the United States and Philip Morris International responsible for the rest of the world. In the United States Marlboro has a 43.3% market share. Altria also owns Black & Mild, the leading tipped cigar brand as well as a portfolio of niche brands such as Parliament and Benson & Hedges. Outside of the US, Marlboro's position is less monopolistic, however PMI still commands the lion share of combustible tobacco volumes.



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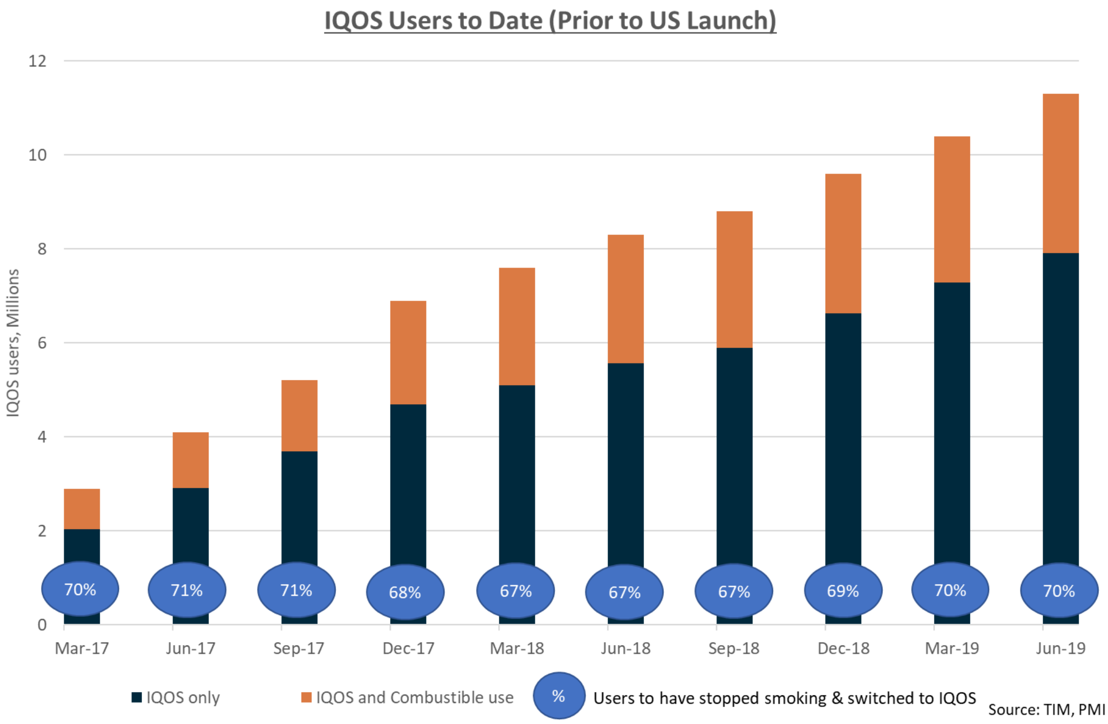
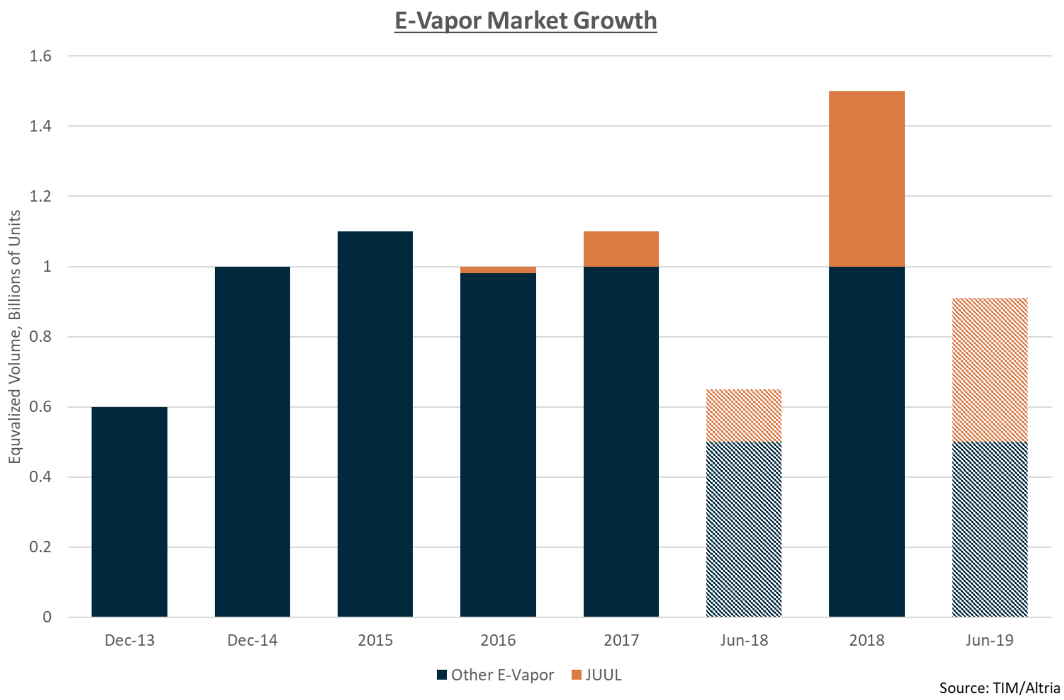
Of note within the chart above is that IQOS, Philip Morris International's heat-not-burn (HNB) reduced risk product has grown to become the 8th largest selling tobacco brand outside of the US. Having submitted premarket tobacco product applications to the US Food and Drug Administration (FDA) in 2017, IQOS finally obtained regulatory approval earlier this year and Altria has an exclusive licence to start selling it within the US. Given the adoption of IQOS outside of the US, and the conversion rates of combustible tobacco user to IQOS only, the revenue potential to Philip Morris is substantial and should help to offset the structural decline in the combustible market.



While Philip Morris continues to make further investments and improvements to the IQOS product it has also designed an e-vapor product known as IQOS MESH which was piloted in the UK in 2018 and it planned to be rolled out internationally by 2020. At the same time Altria has invested heavily in non-combustible tobacco products, most notably taking a 35% stake in JUUL which has accounted for almost all the growth in the US e-vapor growth since its launch in 2016. Altria also has an 80% stake in on! oral nicotine pouches and it owns the two leading moist tobacco brands, Copenhagen and Skoal which command 34.8% and 15.6% market shares respectively.

Although JUUL has been in the regulatory crosshairs in the US and is currently under an FDA probe while the Federal Trade Commission (FTC) is investigating its marketing practices. It has sought to address the concerns over youth uptake of its products and has stopped shipping any exotic flavours (such as bubble-gum and cotton candy) and now only sells tobacco, menthol and mint to retail. Furthermore, it has enhanced 21+ verification and stopped promotional use of US social media. To date it is the only major vaping company to stop shipping flavoured products outside the traditional tobacco flavours. Despite this, we are not seeing any reduction in their growth in market share. JUUL has just launched in 13 international markets and thus will be in competition to MESH, so there could be an argument for combining their efforts in distribution and more targeted marketing.



Altria also recently paid $1.8 billion for a 45% stake in the Canadian cannabis company, Cronos, which opens the door to new markets, although they are at pains to state the investment is to allow Cronos to focus on cannabinoid innovation, rather than developing a tobacco/cannabis product. With further stakes in Anheuser-Busch InBev and St Michelle wine, Altria has may assets which Philip Morris International has no exposure to.

The proposed plan is for a merger of equals with no premium being paid, which should be some relief to PMI investors, who are currently in line to own 57% of the combined entity. However, as a Global Fund we had the option to invest in either company but had chosen to invest in PMI owing to its narrow focus on HNB and combustible tobacco compared to Altria's more diversified portfolio of products, so the merger causes us to re-evaluate as to whether the benefits from becoming the behemoth of the industry, with fingers in multiple pies, outweigh the more focussed approach.

Altria currently has a dividend yield of 7.5% and PMI a yield of 6.5% so the combined entity is likely to remain attractive to income investors and despite the secular decline in the core markets. Their brands are at the premium end of the spectrum which allows them to have strong free cash flows[1] that supports both the dividend and innovation in their new products. We feel that Altria has more to gain from the deal as PMI is the ideal partner to help them roll out their younger products owing to their global footprint while conversely Altria was already set up to market PMI's IQOS in the US.

Eleven years ago, when the company split, it was facing multiple litigation charges owing to the side effects of smoking, with this re-merger PMI is entering a market where there are numerous headwinds such as declining volumes, a motion to raise the legal age to purchase tobacco to 21, FDA investigations into whether e-vaping encourages teenagers to smoke and a possible ban on menthol.

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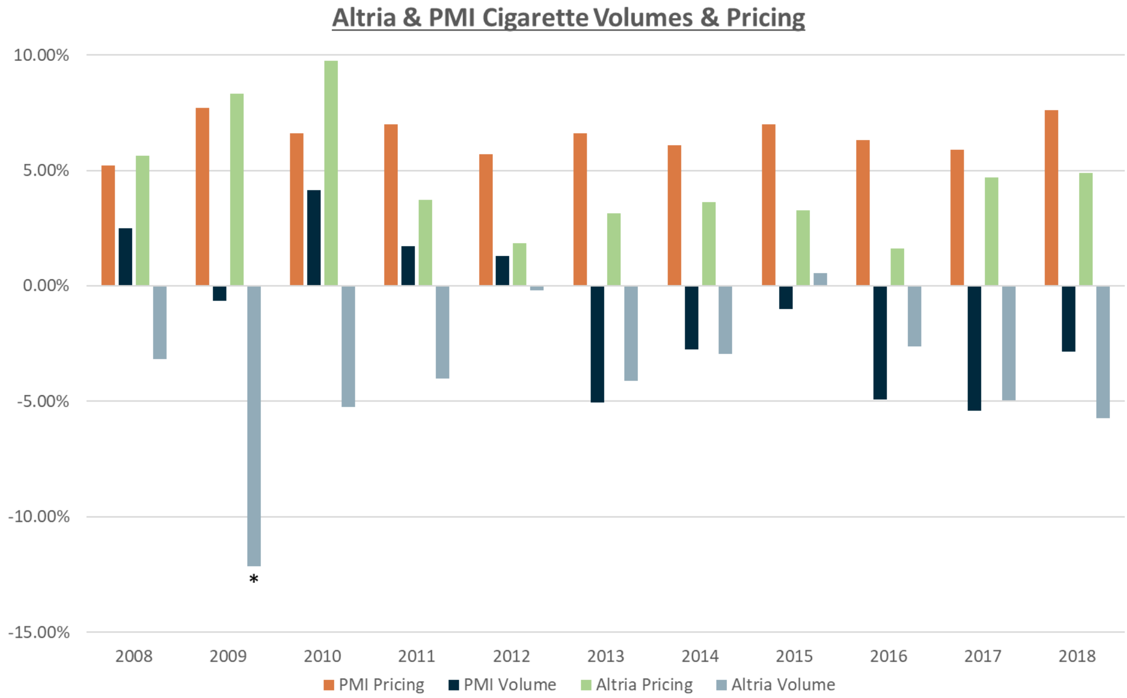
[1] PMI currently has a FCF yield > 6.5% and Altria's FCF Yield is 8%

While the decline in the combustible market will continue. the e-cigarette market is expected to grow at a CAGR of 8% for multiple years and the HNB uptake has a similar trajectory. Encouragingly both products already have higher margin than traditional cigarettes despite their lack of scale to date. As the volumes of alternative products grow and investment levels reduce, the outlook should look stronger rather than relying on the current strategy of raising prices to offset the volume decline.



*Exacerbated by Federal Exercise Taxes increasing from 62c per pack to $1.01

Source: TIM/ PMI/ Altria

Note: The Altria numbers also include the impact of Cigar volumes and pricing, to which PMI has no exposure.

To date, the market reaction would suggest that Investment Bankers, who are pushing the deal, and investors are at loggerheads as to the benefits of a re-merger. We will continue to monitor the situation closely, and although we like the lack of premium being paid by PMI, the terms of any forthcoming deal and US regulatory rulings will be important factors in deciding whether we continue to hold PMI in the Fund.